File

2-5-51

For release in morning newspapers,
Saturday, January 27, 1951.

90

THE ROLE OF THE FEDERAL RESERVE IN WARTIME

An address by Thomas B. McCabe, Chairman,

Board of Governors, Federal Reserve System, #

before the American Academy of Political

and Social Science, Philadelphia, Pennsylvania,

January 26, 1951.

THE ROLE OF THE FEDERAL RESERVE IN WARTIME

An address by Thomas B. McCabe, Chairman,
Board of Governors, Federal Reserve System,
before the American Academy of Political
and Social Science, Philadelphia, Pennsylvania,
January 26, 1951.

On my way here tonight, I felt very guilty about leaving Washington at this critical time -- much like a small boy who is playing truant in order to join his old friends at the favorite swimming hole. Had I followed my head instead of my heart, I would have promptly and decisively refused the last of Dr. Patterson's cordial invitiations which I received last autumn. But I wavered which, as you know, is fatal. That gave my good friend, Al Williams, a golden opportunity to put me on the spot, and finally in December I decided to come.

I am one of the Philadelphians who can never repay Dr. Patterson for keeping the flame of freedom burning in this historic Academy, this forum which carries forward the tradition of Benjamin Franklin's junta, a society that represents the culture of Philadelphia in its truest sense. The members of this society are true exponents of the maintenance of Philadelphia's rich heritage in our democracy -- men and women devoted to our country, quick to expend themselves in its service, concerned for its future, and possessed of the background and capacity to evaluate its problems.

Surely, I thought, in these "times of troubles" I would lack neither the topics nor words for an appropriate address. Little did I reckon with the march of events, with the demands of this, my homeplace, with the dictates of my conscience, or with the brilliance of the preceding speaker. I felt very humble when I appeared before the Douglas Subcommittee of the Congress more than a year ago, when Les Chandler was chief braintrust to the exceptionally able Committee, and I had to withstand for hours a grueling cross-examination on the intricate and complex problems of money and credit. Les is one of the very few men in this country who has mastered these subjects and attained a position of renown throughout the financial community. It is good to know that his proficiency and commanding talents are available in these critical times. He is one of 400 economists who recently joined in a public statement on anti-inflationary measures. The statement issued by this distinguished group strongly supports the program which the Federal Reserve has been pursuing and will continue to advocate in its efforts to combat inflation and to maintain the integrity of the dollar.

You will recall that five years ago this month the Academy devoted an evening to a discussion of the Bretton Woods Agreements -- a subject which at that time was of major importance to the country. I had the privilege on that memorable occasion of sharing the platform with the then Secretary of the Treasury, now Chief Justice Vinson. Never was I more proud of Philadelphia than then, because this was the only major city in the United States in which ten of the leading banks came out boldly in a joint public statement endorsing the International Bank and the Fund.

There is no place where I could speak with more confidence and understanding than here among my old friends and favorite haunts. Many of you have gone to extraordinary lengths to counsel, advise and support me in periods of stress when I really needed your help and the warmth of your friendship. I feel I stand on hallowed ground in a city where the spirits of Alexander Hamilton, Robert Morris, Thomas Willing, Benjamin Rush, Jay Cooke, and many others still live in our memories. These men had the vision, the courage, and the pioneer spirit to give Philadelphia its reputation as one of the great financial centers of our country.

It was here that the first central bank of the United States was established. And here that the great debate between Alexander Hamilton and Thomas Jefferson took place. Hamilton, who fathered the first Bank of the United States, insisted that it should be under private, not public, direction, under guidance of individual interest, not of public policy. Jefferson, who distrusted centralization of financial power under private direction, insisted that central banking be a public function subject to public control. The differing philosophies of these two great men have been debated vigorously through the years. It was Nicholas Biddle and his second bank that were subjected to the burning wrath of President Andrew Jackson when the question of the renewal of the charter of that institution became the focal point of political combat in that era.

It was also in this Third Federal Reserve District about forty years ago that Woodrow Wilson and Carter Glass held their initial conference in Princeton which gave birth to the Federal Reserve System. Wilson, who had been greatly concerned about the monetary situation of the country, had made revision of the currency and the banking laws a matter of first priority for his new administration. Despite his confinement to bed with a severe cold, he summoned Mr. Glass to his Princeton bedside for a two-hour session at which the proposed Federal Reserve Act was developed. I was in Swarthmore College at that time, and as a student of money and banking shared in the civic excitement that launched this country on its third attempt to create a central banking mechanism -- the Federal Reserve System.

It was here about thirteen years ago that I was called upon to be Chairman of the Federal Reserve Bank of Philadelphia. It was from here that I five times departed to undertake tours of public service, most recently to become Chairman of the Board of Governors of the Federal Reserve System.

Tonight we meet in a community which is recognized as the virtual "cradle of thrift" in these United States. When we consider how war and the makings of war erode the savings of our people, it is clear that Philadelphians will be particularly concerned to see that the present defense program is financed in such a way as to safeguard the value of these savings.

Today well over 100 billion dollars of the savings of our people are set aside in government and private programs for retirement, pensions, and insurance protection. Additional billions reside in savings accounts in our banks, in mutual savings banks, and in savings and loan associations. Still other billions are invested in Government bonds.

Every one of us counts heavily on these thrift reservoirs to guarantee our future security. Tonight I want to tell you of the great concern of the Federal Reserve over the steady decline in the purchasing power of these savings and its efforts to arrest any further decline.

I wish there were time for me to tell you the full story of the Federal Reserve System. If I could, I think all of you would have a better understanding of why I have devoted so much of my life to it. Perhaps then you could realize the depth of my conviction that it represents the last bulwark of the private enterprise system.

I would like to analyze the Federal Reserve Act so that you could see why it is such a monumental piece of legislation; how it adheres so closely to the historical concept of the proper role of a central bank; how it has profited by previous experiences, and has blended the best of the philosophies of Hamilton and Jefferson into a unique democratic institution devoted to the public interest in the broadest sense.

The Federal Reserve System was created by Congress. There is not the slightest doubt that it could likewise be destroyed by Congress, or that it would be destroyed or radically altered if it pursued policies against the public interest, as interpreted by the people's elected representatives. But the point I wish particularly to emphasize is that the Congress deliberately sought to insulate the Federal Reserve from predatory and political pressures.

I would like to tell you from my own experiences that I have never seen men take their responsibilities more conscientiously or display greater loyalty than those on the staffs of the Federal Reserve Banks and of the Board.

Their proficiency and farsightedness are recognized the world over if we may judge from the innumerable requests from the central banks of other countries who seek the advice and counsel of our staff on problems of organization and operation. I think you would be interested, too, in the instances where men, coming to Washington in many different capacities, have asked the Board for help and consultation. They appreciate the competence and objectivity of our staff.

I wish I could tell you about the directors of the Federal Reserve Banks and branches. You would be impressed by the extremely high caliber of the men from industry, agriculture, education and finance who give so generously of their time to serve their country in this fashion.

Tonight there is not time even to touch the highlights of this thrilling story. Events are taking place with breath-taking rapidity. Tomorrow's problems are arriving ahead of schedule.

On the one hand, we have the problem of mobilizing our manpower and our resources for defense. At the same time, we have the problem of maintaining a sound economy and a sound dollar to back up our military efforts. I am convinced that these are not two separate problems and that we will be making a terrible mistake if we consider them so. I am convinced that you can't solve the one without an attempt to solve the other. You can't maintain a defense program without a sound dollar.

In the past six months we have given top priority -- and rightly so -- to a reassessment of our international position, and to the development of a comprehensive military program. We have given urgent consideration to procurement problems and production problems. Now that these programs are launched, the next order of business must be to work out a comprehensive program for maintaining the integrity of the dollar -- a comprehensive program for mobilizing our financial resources.

That directly involves the Federal Reserve. As the nation's monetary authority, it is our statutory responsibility to be a special guardian of the integrity of the dollar. Our function is to press for a comprehensive credit and monetary program to prevent a "built-in" inflation that would plague us in the years to come. It is the duty of a central banking organization, because of its unique position in the government, to bring these questions to the foreground of public attention.

The overriding problem which any government faces in a period of war or of large-scale defense preparations is how to raise the staggering amounts of money that are required without permanent injury to the economy. I cannot overstate the importance of the methods by which these funds are raised, whether it be by taxation or by borrowing. If the job is done properly, the whole effort to stabilize the economy and preserve the soundness of the dollar is made immeasurably easier, both now and in the future. If done badly, it is no exaggeration to say that it is possible to destroy the very society we are struggling to preserve.

History is replete with examples of the disastrous consequences of reckless reliance on central banks to finance war expenditures. Even in our own country, the present complications in debt management and monetary policies are in no small measure related to recognized deficiencies in the financing of World War II. As the President so clearly and correctly pointed out last Fall, "We borrowed too much and did not tax ourselves enough. We must not run our present defense effort on that kind of financial basis."

Now, what does this mean for our present problem?

I am just old-fashioned enough to believe that if we are going into a garrison state, and we may be in that garrison state for years, it is absolutely imperative and essential that we start right. And starting right means that we start with a balanced budget and a sound fiscal program. Otherwise, deficits will accumulate and the inflation cannot be controlled.

I think the primary problem before the American people is just how much security do we need and how much security are we willing to pay for. It is as simple as that. Unquestionably, our military needs are enormous and rightfully so.

Obviously, if all-out war were to come, we would be faced with an entirely different set of circumstances and military requirements. At this stage, however, we must provide for a security program that can be indefinitely sustained. Too often in the past our people have changed radically in their thoughts about security and the size of the military forces. We have been like a pendulum. At times like Pearl Harbor we have gone to great lengths, spent money to any degree to get security. And then when the immediate threat was over, the pendulum swung to the other extreme where we were willing to pay for very little in the way of military forces.

We must come of age in this matter of military force and have a well thought-out program. Now that we have started, it must be one that can be sustained. My greatest fear is that if we go too far during this period, the people will not continue to support the program. If we do not go far enough, then the threat of attack becomes greater because we will not be prepared. Therefore, we must bring sound judgment and reason to meet this problem today.

I, for one, am willing to spend every dollar for defense that the people of the country are willing to pay for. And I am willing to pay to the limit of our ability to pay. The limit on our ability to pay is not measured so much by the personal sacrifice as it is by the possible impairment of our economy. It seems to me that is the only consideration -- the possible impairment of our economy. If we tax too heavily we could impair it, but I have not heard any amount of taxes recommended yet that, to my mind, would seriously impair the economy if the taxes are apportioned in the proper way.

People are willing to sacrifice if they know the story -- know that the dollars taxed out of their pockets are buying security and are not being squandered for non-essentials. Certainly, if we have the right to draft eighteen-year old boys against their will and ask them to pay the greatest price of all, it seems to me that we are not unreasonable in asking those who stay at home to give up something.

So, the first fundamental principle in fighting inflation is a balanced budget and, preferably, receipts substantially in excess of expenditures so we will have a little more ammunition to fight inflation.

Right now -- before the rate of defense spending builds up -- is our chance. Never has our economy been more prosperous. Never have we been in a better position to absorb higher taxes without impairing that economy. When I read that it may be the end of summer before a tax program can be enacted, I think strongly we are wasting six or seven months we can ill afford to lose in the battle against inflation.

You may have noticed that my distinguished friend, Senator Robertson of Virginia, has recently advocated a "quickie" tax measure to plug this gap. I have no doubt that the Government's tax experts would welcome an opportunity to provide the Congress with specific recommendations for attaining this objective.

I am realistic enough to know that there is a real danger that the Government will eventually be running in the red despite the efforts to put the defense program on a pay-as-you-go basis. If we do start borrowing again, we must not forget that some kinds of borrowing are much more inflationary than others, and that the most inflationary source of money is that raised through the banking system.

When funds are raised directly from the banks, the money supply is immediately increased. This adds to civilian buying power and in a period when scarcities prevail, builds up inflationary pressures.

To the extent that we borrow from individuals through the sale of savings bonds and from insurance companies, mutual savings banks and other reservoirs of savings, money is being absorbed that would otherwise be available for spending and investment. So long as these funds remain invested in Government securities, their inflationary effect is deferred -- that means that the purchasers as a whole must hold on to them, not redeem them or sell them in the market. I wish to emphasize that so long as these funds <u>remain</u> invested in Government securities, their inflationary effect is deferred. This is the crucial test of effectiveness and must be a keystone of debt-management policies.

The trouble arises, as it has in the postwar period, when these securities are subsequently sold either by banks or nonbank investors, particularly when they are bought by the Federal Reserve. Then the banking system is furnished with "reserve dollars". These have accurately been called "high-powered" dollars because they can become the basis for a multiple expansion of credit.

About one-fourth of our total expenditures in World War II was raised through borrowing from the banking system. As a result, our total money supply more than doubled during the war. Since then it has risen further, and today amounts to over 175 billion dollars.

I would like to summarize the main lessons from our experience in financing World War II -- first, we did not tax enough; second, too large a portion of the borrowing thereby required was raised through the banking system; and third, too large a portion of the funds we raised from nonbanking sources which, though they were saved at the time, did not remain immobilized after the war. The inflationary problems of the postwar period with which we are all so painfully familiar resulted in large part from the expanded money supply and also from the sales of Government securities by insurance companies, banks, and other lenders to the Federal Reserve System. Too many individuals and institutions liquidated all or a portion of their bonds and spent the cash or reinvested it as opportunity presented itself.

We must do our utmost to avoid repeating these mistakes.

In addition to financing the Government as much as possible through taxation and borrowing from nonbank investors, the next requisite for fighting inflation is to restrict credit. Credit of various kinds has been vital to the development of this country. Credit is absolutely essential for the defense effort as well as for the sound functioning of the economy. But we have had far too much credit for the postwar inflationary period. If we are to have steady economic progress, we should severely restrict credit in periods of inflation and be liberal with credit in periods of recession. This task is the statutory responsibility of the Federal Reserve.

It is not necessary here to do more than enumerate the various instruments of credit regulation that may be used. They are of two broad types -- (1) general instruments and (2) selective instruments. The first group includes measures, such as the rediscount rate, Federal Reserve open market operations, and the fixing of reserve requirements, through the use of which the Federal Reserve can influence the supply of funds that banks can lend. The selective instruments place limitations on particular types of credit. These include margin requirements on stock market loans, regulation of consumer instalment credit and similar regulation of mortgage loans. Both types of measures have already been used by the Federal Reserve to restrain credit expansion. It appears likely that further restrictive action may be required.

I have indicated that, in my judgment, the overall program adopted to finance World War II was inadequate. I feel also that the Federal Reserve went too far in the direction of inflexibility. We profited by that experience as the subsequent record shows. I ask you to look at that record. It speaks for itself. It exemplifies more eloquently than any words I could utter. our determination to continue to work unceasingly for a program adequate to meet the needs of the times.

The final essential in fighting inflation is the promotion of savings.

I have no use for those who scoff at the E Bond campaigns today. They simply do not realize the implications of their statements when they discourage people from saving. The average working man who buys E Bonds is investing money that he would ordinarily put into gadgets or little richer cuts of meat. The real significance of the E Bond campaigns is not only to get people to save and thus help to combat inflation, but at the same time to give them a financial stake in the Government. This is the same principle that has led enlightened businessmen to encourage employee stock ownership.

I am convinced that, even though the purchasing power of the dollar has diminished, the people whose E Bonds are maturing this year will have more to show for their dollars than would otherwise be the case. Those dollars would have gone into many things and they would have little or nothing to show for them today. From the broader point of view of support for our Government, some, like the boys in Korea, are risking their lives, others devote their talents to public service, still others take leadership in civic affairs. But practically all of us can save something to invest in Government securities.

The lessons of what inflation does to a man's savings are something we cannot overlook if we are to escape serious social repercussions in the years ahead. The difficulty is that the inflation process is not unlike a habit-forming drug that lulls our sensibilities to these realities. Actually, inflation as we have thus far experienced it in this country has not been hard to take. Wages have increased faster than prices. Business profits have risen to unprecedented levels. The farmer has enjoyed substantial gains in real income. Consequently, it is extremely difficult to get the public as a whole to fight an enemy who masquerades as Lady Bountiful.

If we are to conquer the inflationary forces inherent in our present situation, we must deal with the fundamental causes I have discussed.

Only because so many of my friends in Philadelphia have asked me, "What can I do as an individual about such a vital problem?", will I attempt to suggest an answer to this question.

Many of you are officers and directors of various kinds of business enterprise throughout this community. In your various capacities you can make valuable contributions to the fight on inflation by making sure that the business is not accumulating excessive inventories, or following other policies that contribute to inflation. A short time ago I asked a group of bankers these questions: How many loans have you made during the past six months that were not really essential? In how many cases have your customers' needs required the full amount they have borrowed? In how many cases have you renewed or extended loans when a part, or a larger part, might have been paid off? These same questions apply to insurance companies and all lenders. The sum total of these marginal amounts has swelled the money supply and added an increment of buying power to the market that is reflected in the rise of prices, wages, and costs in general, and in the scarcities that pervade the market today.

Furthermore, there are great opportunities for action in this emergency by civic groups. Collectively, your influence may be multiplied not only locally, but on the national level as well. You can help immeasurably to focus attention on what I consider to be the Number One unresolved problem of today -- Inflation -- and on the comprehensive approach that is needed to deal with it.

Undoubtedly, the greatest result of all will come if each of us will take leadership in the practice of voluntary self-restraint. This is no time to splurge, to be extravagant, to spend unnecessarily. It is no time to finance such spending on the part of others, to countenance such spending, or to give it social sanction. Let us not underestimate the force of voluntary self-restraint. We live in a social environment and we respond in our actions to forms of behavior that are approved. We know that hoarding and extravagance can be contagious. So can restraint.

Inflation is not inevitable.

It is true that sacrifices will be necessary to preserve the dollar but we have demonstrated willingness to undergo sacrifice, supreme sacrifice, once we understand the end in view and the need.

I can have little patience with those who say the American public lacks the courage, the will and the vision to comprehend and to conquer evil forces, whether abroad or at home, that would destroy the institutions which are the source of our incomparable strength and of the hopes of free peoples throughout the world.

Woodrow Wilson, in commenting upon the issues of his day in the monetary and credit field, summarized the role of the individual in this way:

"There is a sense in which a democratic country forces statesmanship upon every man of initiative, every man capable of leading anybody; and this I believe to be the particular period when statesmanship is forced upon bankers and upon all those who have to do with the application and use of the vast accumulated wealth of this country . . . We should seek to give the discussions of such matters such publicity and such general currency and such simplicity as will enable men of every kind and calling to understand what we are talking about and take an intelligent part in the discussion. We must open our thoughts to the country at large, and serve the general intelligence as well as the general welfare."

- - - - - - - - - -